submitted in A.92-05-004, PacBell witness William Taylor specifically argued against making *any* changes in NRF and stated that the plan was

> ... working within anticipated limits, and our conclusion is that tinkering with the details of a working incentive regulation plan would run the risk of diluting the very incentives the plan was established to achieve. ... the triennial review is not a time to true-up details ... If the plan is tweaked every three years so that the regulated firm has a reasonable chance to earn its current cost of capital, we will have simply replaced ordinary rate of return (ROR) regulation with ROR having a mandated three year lag."[3]

Q. Is there any basis for fundamental change at this time?

A. No, there is not. The NRF continues to perform well. NRF LEC rates have decreased by roughly 21% in real terms (exclusive of exogenous cost changes) since the plan went into effect in January, 1990, and both LECs have maintained high levels of earnings — averaging 12% for PacBell and 14% for GTEC, even higher when their respective *interstate* services are included (14% for PacBell and 14.7% for GTEC). Investors have continued to offer premium prices for Pacific Telesis shares (as evidenced by their consistently high and growing market-to-book value ratios) over the period in which the NRF has been in effect. Moreover, there are no fundamental changes in the condition of PacBell and GTEC or in the effectiveness and operation of the NRF since the previous triennial review or, for that matter, since the onset of NRF in 1990, that would justify fundamental change in NRF at this time.

Q. But doesn't the onset of competition at the local exchange level fundamentally change the business climate under which the NRF LECs must operate?

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3. Taylor, William E. and Timothy J Tardiff. "*The New Regulatory Framework 1990-1992: An Economic Review,*" prepared for Pacific Bell, A.92-05-002, May 1, 1992 at ii-iv.

A. No, it does not. The onset of competition (a) is (or should be) no surprise to PacBell or GTEC, and (b) in any event is not likely to engender immediate or significant operational changes for these LECs any time soon. Both through explicit regulatory actions at the state and federal levels and through well-recognized industry trends, the NRF LECs have been on notice that competition was coming, and cannot now claim any specific linkage between the forthcoming onset of local competition and the need for NRF reform at this time.

Q. **What is the basis for your statement that the onset of local competition "is not likely to engender immediate or significant operational changes for these LECs any time soon"?**

A. Even after local competition is nominally authorized by the Commission as of January 1, 1996, it is highly unlikely that it will develop so rapidly as to impose significant economic hardships or other operational constraints upon the NRF LECs' pricing and other practices immediately upon its inception next year. This assessment is, in fact, buttressed by history. It took nearly a dozen years (from divestiture to now) for AT&T's share of the interLATA long distance market to decrease to 60% (see Table 1 on page 7 below). As detailed in Table 2 on page 8, during that same period, while the new IXCs were gaining market share, AT&T's gross interexchange revenues actually grew slightly, while its net (of access charge payments to LECs) revenues actually increased by 63% since divestiture, i.e., at an annual rate of about 6%.

Table 1

INTEREXCHANGE CARRIER MARKET SHARES

Year	AT&T	MCI	Sprint	Other Carriers[1]
1984	90.10%	4.5%	2.7%	2.7%
1985	86.30%	5.5%	2.8%	5.4%
1986	81.90%	7.8%	4.3%	6.0%
1987	78.60%	8.8%	5.8%	6.8%
1988	74.60%	10.3%	7.2%	7.9%
1989	67.50%	12.1%	8.4%	12.0%
1990	65.00%	14.2%	9.7%	11.1%
1991	63.20%	15.2%	9.9%	11.7%
1992	60.80%	16.7%	9.7%	12.8%
1993	58.10%	17.8%	10.0%	14.1%
1994	59.70%	18.8%	10.9%	10.6%

1. Other carriers market share includes share of LDDS Communications, Inc.

Source: Long Distance Market Shares, Fourth Quarter 1994, Industry Analysis Division, Common Carrier Bureau, FCC, April 1995; and 1994 data from Common Carrier Competition Report, Common Carrier Bureau, FCC, Spring 1995.

Table 2

INTEREXCHANGE CARRIER REVENUES FROM INTEREXCHANGE SERVICES
(Dollar amounts shown in millions)

Year	AT&T Gross	AT&T Net[1]	MCI Gross	Sprint Gross	Other Carriers Gross[2]
1984	$35,036	$14,404	$1,761	$1,052	$902
1985	$37,458	$15,937	$2,331	$1,509	$1,821
1986	$36,629	$17,037	$3,372	$2,132	$2,286
1987	$34,983	$17,395	$3,938	$2,592	$2,638
1988	$35,277	$18,498	$4,888	$3,405	$3,264
1989	$34,277	$19,413	$6,171	$4,320	$5,431
1990	$33,534	$19,498	$7,392	$5,041	$5,789
1991	$33,926	$20,140	$8,266	$5,378	$6,413
1992	$34,992	$21,271	$9,719	$5,658	$7,494
1993	$35,545	$22,115	$10,947	$6,139	$8,716
1994	$36,877	$23,517	$11,715	$6,805	$6,611

1. Net of access charge payments to LECs. Despite a decrease in market share from 90% to 60% during the period, AT&T interexchange revenues net of access charge payments increased by 63%.

2. Other Carriers market share includes share of LDDS Communications, Inc.

Source: Long Distance Market Shares, Fourth Quarter of 1994, Industry Analysis Division, Common Carrier Bureau, FCC, April 1995.

Q. Why do you believe that this pattern will apply to the local exchange market as well?

A. In fact, LEC local service market share erosion will likely occur far more slowly than that experienced by AT&T with respect to its long distance business. For one thing, and unlike the case with long distance services, customers electing to switch from the incumbent LEC to another facilities-based provider may be required to undergo a *physical installation* of the new entrant's services at their homes or businesses, involving the placement of new drop wires, terminating equipment, and in some cases rearrangements to the customer's premises wiring. When a customer changes long distance carriers, no such installation effort is involved; instead, the LEC is simply advised to enter the new primary interexchange carrier (PIC) on the customer's service record so that interLATA calls dialed on a 1+ basis will be routed to the selected IXC. It has been estimated that in 1994 some 30-million customers switched their long distance carrier,[4] yet none of these involved a premises visit.

Q. But hasn't the elimination of the LECs' legal monopoly on local services provision in California made them vulnerable to competitive entry?

A. No. Even though their legal monopoly no longer exists in California, Pacific Bell and other incumbent LECs derive substantial and enduring market power from the ubiquitous, interconnected networks that were constructed under the protected monopoly model and with funds essentially guaranteed by captive ratepayers.

Large network infrastructures, such as Pacific Bell's network, are characterized by centralized control of network connectivity and large economies of scale and scope. Hence, control of an extensive network is a source of enormous market power, since the

4. See, *Look what competition did to long distance prices. Now Imagine what competition could do to local telephone rates...*, AT&T Report, 1994.

properties of such networks create substantial externalities to both supply and demand. The larger the number of users in the network, the lower will be the unit cost per user. At the same time, as the number of users increases, the network becomes more valuable. This dynamic, due to the presence of externalities and the level of interconnection among users, allows the network owners to establish extensive market power.

Telecommunications network resources involve very large investments that are most efficiently recovered over the largest number of users. Therefore, the degree to which LECs are able to exploit their network resources to accomplish an efficient scale and scope of operations will facilitate its advantageous market position vis-à-vis smaller rivals. A LEC's network sources of market power include, among other things, the scope and scale of interconnected network facilities; control of points of traffic aggregation (i.e. switching centers); direct access to virtually every end user within the service territory through billing and ongoing business relationships; and a starting point of virtually 100% market share in its serving territory.

In addition, there are numerous, significant barriers to competition in the most important segments of LEC markets. Unless the Commission takes aggressive steps to substantially reduce or eliminate these barriers, widespread competition is unlikely to develop.

Q. But even if it happens slowly, won't the erosion of the incumbent LECs' market shares leave these firms with idled plant whose costs might not be recoverable once a customer switches to another local telephone company?

A. No. In considering the impact of local competition upon LEC investment recovery, it is critical that one look at the incumbent LEC *in the aggregate*, as a *going business*, rather than dwell on the micro impact of competition in individual customer installations. The two NRF LECs have had *and continue to have* ample opportunity to effect modifications in their cost structures to accommodate for the rate at which any financial impact of competition is likely to occur. The two NRF LECs are each replacing some 9% of their embedded plant in service each year;[5] at the end of five years, nearly half of the existing plant will have been retired and replaced. The NRF LECs can easily accommodate any market share erosion by adjusting their capital spending to reflect any reduced need for capacity that a market share loss might create.

Q. But if local competition does take hold, won't it then be appropriate to substantially modify or even eliminate the NRF as it applies to Pacific Bell and GTEC today?

A. The present structure and operation of the NRF is self-limiting. The purpose of the NRF — or, for that matter, of any system of economic regulation — is to achieve a "competitive outcome" in the presence of market failure, i.e., under conditions where unique conditions of production, distribution, legal constraints, extreme market concentration, or other factors prevent a competitive market from developing. The NRF represented a major transitional step in the evolution of modern economic regulation to accommodate the development of limited and specialized niche market competition in certain sectors of the incumbent LECs' traditional monopoly. As additional competition develops in additional market segments to a point where it acts to constrain the NRF LECs' prices and earnings, the existing NRF would simply "drop out" on its own, and the "competitive outcome" would be achieved instead by competitive marketplace forces. If the development and growth of local competition ultimately changes the competitive landscape, that change will in any event be gradual and there is no immediate need to revise the existing regulatory paradigm.

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5. During the period of 1990-1994, PacBell and GTEC replaced plant in California at an annual rate of some $1.7-billion and $530-million respectively. This represents about 9% the LEC's total plant in service.

Q. In several *ex parte* contacts and written submissions, Pacific in particular has claimed to have experienced significant market share erosion in the intraLATA long distance market since competition was authorized as of the beginning of this year, and has also claimed that the level of demand stimulation resulting from the large intraLATA toll rate decreases has failed to materialize.[6] Are such claims (whether proven or not) relevant to a consideration of the efficacy of the present NRF?

A. No, they are not. When you start out with 100% market share and introduce competition, it goes without saying that (unless competitive entry is effectively blocked or frustrated by the incumbent) the incumbent will necessarily lose market share. Indeed, the LECs have (at least publicly) supported competitive entry as a *quid pro quo* for their own increased regulatory and earnings flexibility — what one might think of as a "new regulatory bargain" in which LECs give up their absolute monopoly in exchange for the ability to increase earnings above the traditional "fair return" level. As such, claims as to competitive losses arising from intraLATA toll competition that began in January, 1995 are consistent with the expectations of NRF and are thus irrelevant to NRF reform. In IRD, the Commission expressly rejected the LECs' claims for "make whole" compensation for such losses;[7] to the extent that competitive losses or the extent of competitively-driven price decreases may have exceeded the LECs' projections is precisely the type of risk that NRF LECs are and should be expected to assume and to

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6. See Pacific Bell ex parte notices filed May 4, May 9, May 10, May 15, May 17, May 22 and July 13, 1995. See also, *Joint Petition of Pacific Bell and GTE California, Inc. for Modification of D.94-09-065*, filed September 1, 1995.

7. CPUC D.94-09-065, September 15, 1994, at 164.

accept. Efforts to reargue issues in IRD, such as demand stimulation, are not appropriate in the NRF Review proceeding, having been addressed and disposed of in previous decisions, and having been raised again by the Joint Petition of Pacific Bell and GTEC that was filed last week in the IRD proceeding.[8]

The NRF LECs' investment recovery and overall financial condition — and hence the appropriateness of the ongoing rate adjustment mechanism — must be assessed in the aggregate and not on an asset-by-asset basis.

Q. Is there reason to believe that Pacific Bell and GTEC investors are satisfied with the ongoing operation of the NRF?

A. Indeed there is. Investor evaluations of PacBell's financial and business conditions have not undergone any significant change over the term of the NRF — and in fact when adjusted for the effects of the AirTouch spin-off, Pacific's share values have actually *increased* relative to the Company's book value since the onset of NRF in January, 1990 (see Figure 1 on page 14 below). A recent report by Salomon Brothers, circulated as *ex parte* filing by PacBell in July,[9] describes that LECs "...have high-margin monopolies today that are just beginning to face competition...."[10] The same report also explains that "...despite the complaints from the Bell executives, the market is in fact reflecting value in their stocks for non-Bell assets."[11] From the Salomon report, one can readily

8. *Op. cit.*, **footnote 6.**

9. ***Regional Bell Operating Companies*** *(RBOCs)* — ***Creeping Competition in Local Service Implies Shrinking Margins and Market*** *Share for RBOCs*, **Salomon Brothers, May 22,** 1995, submitted as a Notice Of ***Ex parte*** Communication by Pacific Bell, July 13, 1995 ("Salomon Brothers report").

10. *Id.* at 4.

11. *Id.* at 15.

conclude that the principal source of erosion in the value of Pacific Telesis shares is directly attributable to the AirTouch spin-off. When Telesis and AirTouch shares are combined and correctly weighted, the combined market-to-book value ratios for the reconstituted companies is essentially constant over the past several years or, if anything, has increased.

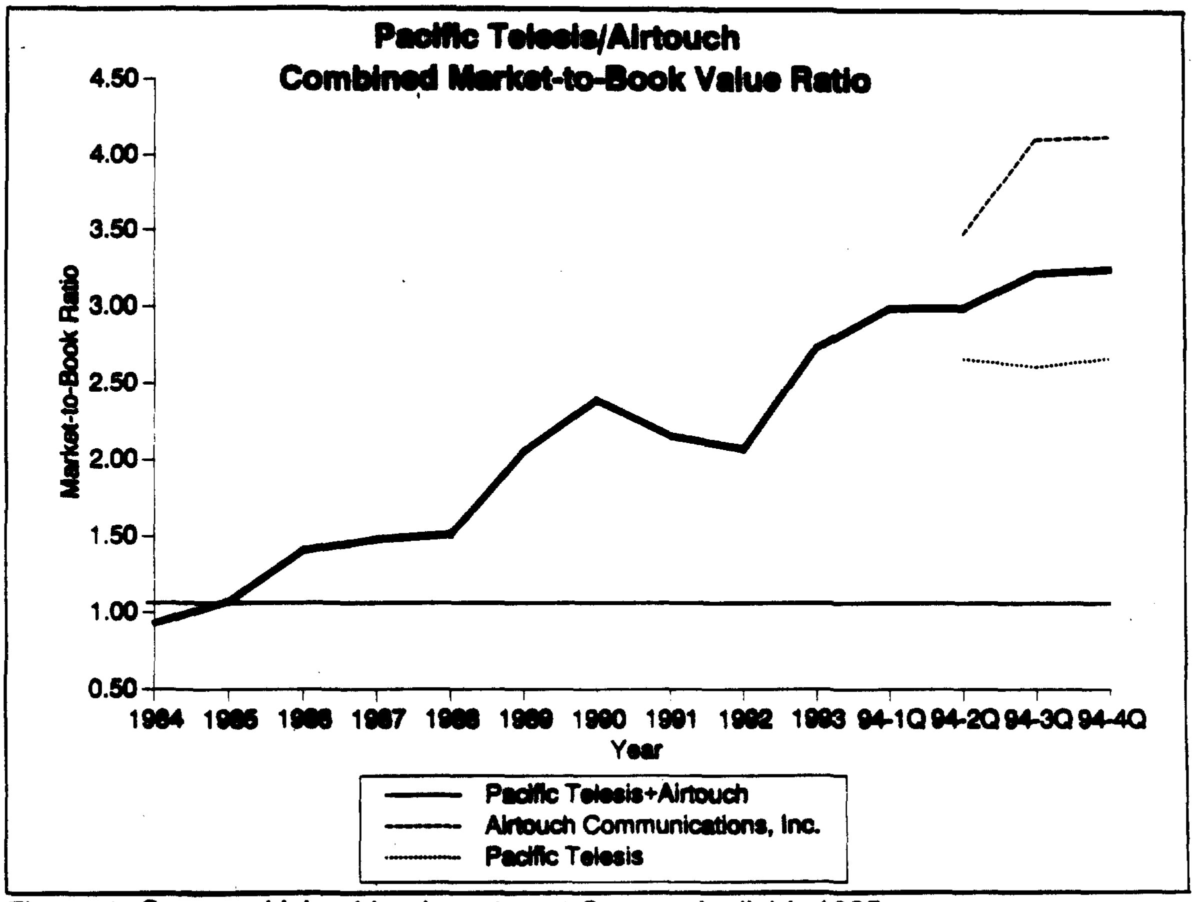

Figure 1. **Source:** Value Line Investment Survey, April 14, 1995

Salomon Brothers characterizes Pacific Telesis as the only "pure LEC" RBOC because, as a result of the spin-off, it is the only RBOC to have few if any non-LEC business interests (at least in relation to the size of the LEC). According to Salomon Brothers' "stripped" RBOC comparable analysis, which compares all RBOCs based upon their telco value only (i.e. excluding all non-telco assets), PacBell's price/earnings ratio is the second highest of the seven RBOCs.[12] This analysis confirms the results of the market-to-book value analysis, which shows that both Pacific Telesis and GTE — the parent corporations of PacBell and GTEC, respectively — are trading at above average market-to-book ratios (see Table 3 and Figure 2 below).

Table 3

LEC Market-to-Book Ratios
as of December 31, 1994

Ameritech	3.6
Bell Atlantic	3.8
Bell South	1.9
NYNEX	1.8
Pacific Telesis	2.6
Southwestern Bell	2.9
US West	2.5
GTE Corp.	2.9
Cincinnati Bell	2.1
SNET	2.2
Rochester Telephone	2.0

Source: *Value Line Investment Survey*, April 14, 1994.

12. According to the Salomon Brothers analysis, the price/earnings ratio for the RBOCs are as follows: 11.8 for NYNEX, 11.2 for Pacific Telesis, 10.8 for Southwestern Bell, 9.6 for Bell South, 9.6 for Bell Atlantic, 8.9 for Ameritech and 6.7 for US West. *Id.* at 16, Figure 1.1.

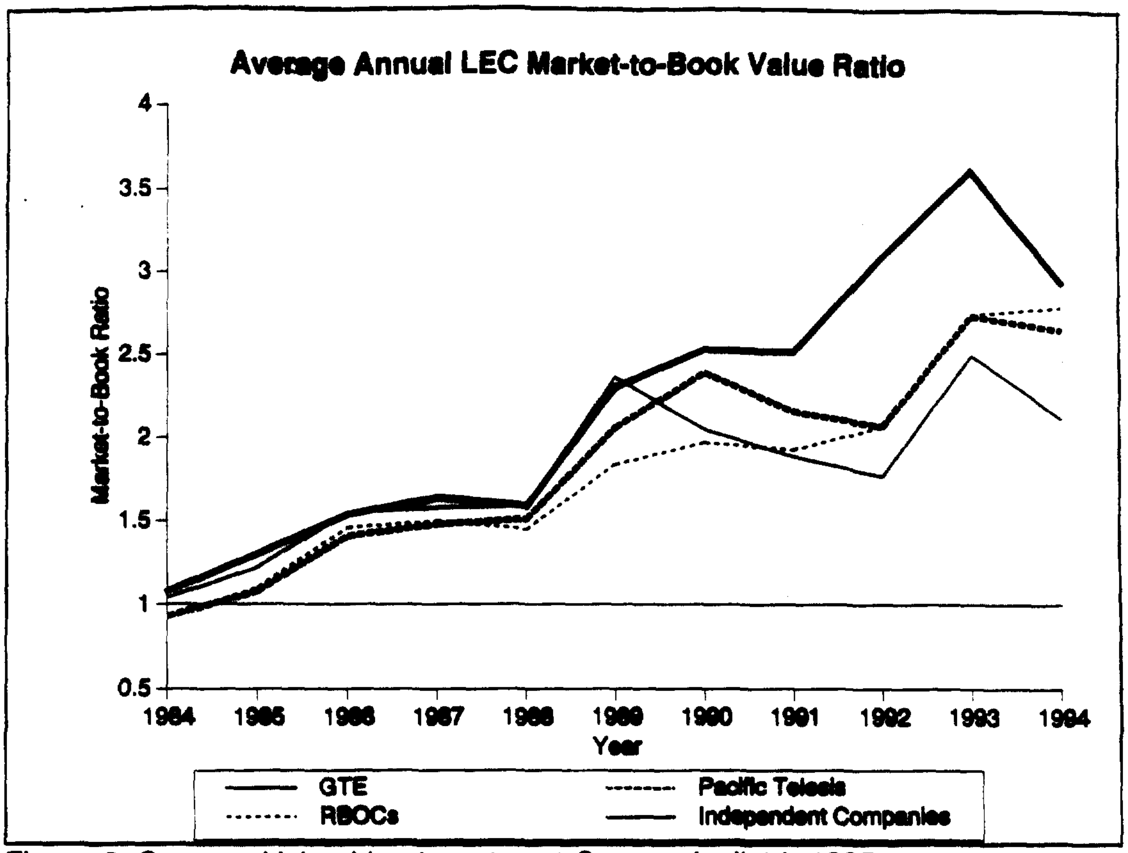

Figure 2. Source: Value Line Investment Survey, April 14, 1995.

Investors clearly do not believe PacBell's rhetoric about the potential financial impact of competition or the erosion of its earnings opportunities in the current regulatory environment. Even after the April 26, 1995 release of the draft Interim Local Competition Rules and the July adoption thereof by the Commission,[13] Telesis shares are continuing to trade in excess of 2.0 times book value, higher than several other RBOCs. As another benchmark, stocks for the principal California electric and gas utilities are trading at far smaller premiums, with market-to-book ratios in the 1.3 to 1.5 range, as is shown in Figure 3 on the following page.

13. D.95-07-054.

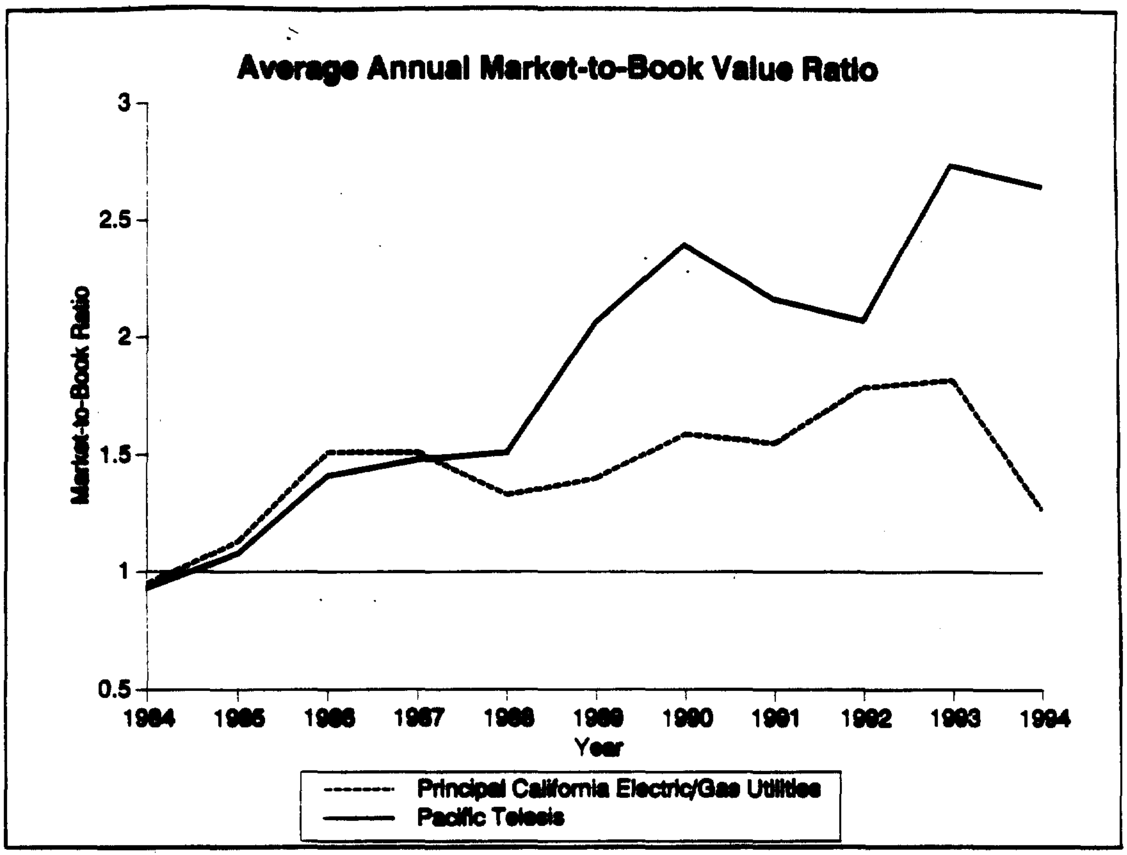

Figure 3

Q. What is the relevance of these investor evaluations to the Commission's assessment of the need for revisions to the NRF at this time?

A. Price regulation — which lies at the heart of the New Regulatory Framework — represents an attempt to fundamentally shift the focus of regulation away from earnings and onto prices. In competitive markets, consumers' principal interest is also in the *prices* that firms charge for their products and services, not in those firms' profitability (or lack thereof) *per se*. Nevertheless, the competitive marketplace is expected to operate so as to constrain the ability of individual firms to earn excessive profits: If the incumbents' earnings levels become excessive, new firms will be attracted to enter the market, bidding down prices and eroding the incumbents' excessive earnings. The presence of sustained excess earnings in a market is an indication that, for whatever reason, competition is failing to fulfill its market regulation function.

Under traditional rate of return (ROR) regulation, utilities commissions look to *accounting* records to determine the value of assets used and useful in the production of the utility's services, and to cash sales revenues and profits to measure the return to investors on those assets. Investors, however, do not focus so narrowly upon solely these "book" items. To an investor, "return on investment" includes growth in the value of the firm's assets, some of which stems from the firm's ability to exploit its assets to generate increased sales and profits in the future. To an investor, "assets" are not just those that exist "on the company's books." They include any number of *non-book* assets, such as know-how, goodwill, trademarks, licenses, patents, and fully-depreciated plant that is still in use, among other things. Investors don't look to the values of individual book assets, they look to the value of the entire firm as a "going business."

As the Commission moves away from traditional ROR regulation, it too must broaden the basis upon which it evaluates the performance of the utilities subject to the NRF or other incentive regulation programs. It must look at the performance of NRF LECs the way investors do. For example, while investors are aware that the onset of local competition may diminish the value of *individual* items of the LECs' plant where *individual* customers switch to another provider, investors also know that the LECs' historic monopoly, their extensive infrastructure, their established commercial relationships with virtually all households and businesses in their service areas, their significant scale and scope economies that enable the existing stock of network resources to be exploited for the introduction and development of new services and markets, among other things, more than outweigh any nominal erosion in the value of individual assets or loss of nominal market share to competing providers. Investors know and understand that many LEC assets are not "book assets" in the accounting sense, and that these companies often have market and going business values far in excess of their assets' original cost. Indeed, as readily confirmed by an examination of LEC share prices and book values, it is clear that investors do not perceive any *net* erosion of asset values to have occurred, and in fact perceive that the "going business" value of the NRF LECs, in light of potential opportunities for market growth, are well in excess of the "net investment" as expressed in the regulatory context.

Q. What conclusions should the Commission draw from the consistently high premiums (relative to book value) that investors have been willing to pay for Pacific Telesis shares since the onset of NRF in 1990?

A. The persistence of high premiums relative to book value implies the presence of one or, more likely, both of two key conditions:

(1) *LECs continue to possess substantial market power*; investors expect that, with additional regulatory flexibility to be allowed in the future, LECs will be able to raise prices relative to cost (or to retain their present price levels despite potentially large cost decreases) and thereby earn supranormal profits.

(2) *LECs will have unique opportunities to exploit assets acquired while under rate of return regulation*; the presence of substantial excess capacity in existing network resources, coupled with broad name/brand recognition and established business relationships, affords the NRF LECs a unique ability to introduce new nonregulated services at minimal incremental cost and risk to LEC shareholders, and thereby to offer investors a substantial expansion of profit opportunities.

The presence of either or both of these conditions provides a strong indication that the existing NRF price adjustment mechanism is unduly generous and that it should be adjusted by *increasing* the offset or "X" factor. The presence of condition (1) suggests that investors are bidding up the value of Pacific's shares to reflect the present discounted value of the excess monopoly profits that the consistently high prices that are permitted under the NRF will generate. The presence of condition (2) indicates that the "consumer dividend" component of the X factor is failing to capture for ratepayers a reasonable portion of the "reward" that should appropriately follow the "risk" that had been imposed upon ratepayers under RORR in supplying the capital to acquire and construct infrastructure assets.

Q. But these actions may adversely impact the value of the LECs' stock — doesn't the Commission have an obligation to permit the LECs to maintain the value of their stock at present levels?

A. No. The Commission has no obligation to adopt regulatory policies whose purpose or effect is to maintain the value of NRF LEC shares at premium levels relative to their book value. The fact that the LECs' shares are trading at a premium demonstrates that the goal of the NRF is being achieved. The fact that the premium is as large is it is relative to other ROR-regulated utilities in California indicates that the existing rate adjustment mechanism is overly generous to the LECs and should be corrected.

The Commission's responsibilities relative to ratesetting are (a) to ensure that rates are just and reasonable and not unduly discriminatory, and (b) to ensure that rates are not confiscatory. The presence of high premium values of NRF LEC shares may reflect the present discounted value of future supranormal profits, suggesting that rates under NRF are considered by investors to produce monopoly profits. For this purpose, "confiscation" can be said to exist if and only if the market value of LEC shares drops below its book value. And given the magnitude of the current premium, upward adjustments in the X factor of the type that I believe to be appropriate will not come even close to causing the LECs' market value to fall below book value.

"PURE PRICE CAPS"

If a "pure price caps" plan is to be adopted as PacBell and GTEC have requested, more than the mere elimination of "sharing" will be required.

Q. What is your understanding of the major revision that Pacific is seeking in the structure of the NRF at this time?

A. It is my understanding that Pacific will propose that the NRF be modified to a so-called "pure price caps" system, which the LECs define as simply the elimination of all sharing of excess earnings and any earnings cap, and the commensurate removal of so-called "low-end" earnings protection — i.e., the right of the LEC to seek rate adjustments in excess of the cap — or even revert to RORR — in the event of a sustained earnings shortfall. I also anticipate that Pacific will seek a significant reduction in the X factor or some other similar revision in the price adjustment mechanism.

Q. Do you believe that the Commission should adopt a "pure price caps" system as is being proposed by the NRF LECs?

A. No, I do not. For one thing, sharing of excess earnings is an important element of an effective price regulation system, and should be retained. However, if the Commission determines that sharing is to be eliminated (either in its entirety or on an optional basis), then a number of additional modifications to the present NRF will be required.

Q. Please explain.

A. Under competitive conditions, a firm would not be subject to any earnings sharing or earnings constraint, except as imposed by the competitive marketplace itself. Similarly, firms are normally not protected against earnings erosion or even serious financial reversals, other than for bankruptcy protection and occasional government "bail-outs." The NRF LECs' view of "pure price caps" appears to be predicated upon simulating these specific attributes of a "competitive" market. However, competitive markets exhibit several other attributes that the LECs appear to have ignored, attributes that bear directly upon the structure of any "pure price caps" arrangement.

Specifically, under competitive conditions, a firm also could not maintain price levels sufficient to recover its historic original costs if competitors could replicate its assets at lower cost due to technological advancements or other changes. *As such, if the purpose of "pure price caps" is to simulate competitive conditions, initial rate levels and ongoing rate adjustments must also be revised to reflect competitive market outcomes.*

Q. Are you suggesting that the present rate levels of the two NRF LECs are more closely tied to historic original cost than to forward-looking costs that these firms — and any competitors — will likely face in the future?

A. Yes, indeed. Although the LECs often portray price cap regulation as somehow severing the link between prices and costs, in fact the existing NRF LEC rate *levels* are actually rooted in historic *embedded* costs and revenue requirements that were initially established under RORR. There are several reasons why this is the case.

First, the "going in" rates and rate levels that were initially adopted by the Commission at the outset of the New Regulatory Framework[14] were expressly based upon RORR. They were designed to satisfy a revenue requirement, determined utilizing traditional RORR methods, based upon a "market-based" rate of return of 11.5%.

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14. D.89-10-031; D.89-12-048, setting the initial NRF rate levels.

Second, the ongoing annual rate adjustments were applied *incrementally* to the initial RORR-based revenue requirement. The productivity growth rates that were used in establishing the X factor were calculated based upon historic conditions extant under RORR, which means that the very same productivity and efficiency experience that prevailed under pre-NRF RORR was, in effect, *extrapolated directly into the NRF rate adjustment process.*

Third, the sharing and low-end adjustments applicable under the NRF are reckoned in RORR terms. That is, the rate of return for these purposes is calculated in the same manner as under RORR — net earnings divided by net rate base. And in calculating "net earnings" and "net rate base" for purposes of determining "shareable earnings" and for low-end adjustment purposes, the very same types of historic depreciation rates and rate-setting methodologies that applied under RORR, based upon accounting revenues and original cost of book assets, are used in figuring realized rate of return on net investment.

Finally, earnings calculations under the NRF expressly *exclude* any and all *non-cash* gains inuring to the LEC or to any of its affiliates that may occur as a direct consequence of ongoing LEC operations. Such excluded items encompass any appreciation in the value of non-book LEC assets, gains from exploitation of regulatory and non-book assets for the provision of Category 3 and non-regulated services and affiliated businesses, and gains in the value of the going business based upon expectations of future supranormal revenues and profits. Indeed, it would be possible, under NRF, for a LEC that had experienced nominal[15] earnings shortfalls of 325 basis points for two consecutive years (the earnings "floor") to seek an upward adjustment in its rate levels *even if it was*

15. My use of the term "nominal" in this context refers to the fact that the *measurement* of realized earnings under both D.89-10-031 and D.94-06-011 is limited strictly to *accounting* revenues less *accounting* expenses, and thus excludes numerous *non-book* elements that investors would consider in evaluating the firm's performance, such as growth, appreciation in market value of book and non-book assets, etc.

simultaneously enjoying extensive non-cash gains and growth in the values of its non-book assets.

The adoption of "pure price caps" without modifications to the NRF other than the elimination of sharing will produce an unjustified windfall gain for the NRF LECs.

Q. What would be the consequences for ratepayers if the Commission adopts the NRF LECs' position as to the elimination of sharing but without making any of the other "pure price caps" adjustments that you have identified?

A. The simple elimination of sharing, but without the other necessary "pure price cap" modifications to the NRF that I have outlined, will produce an unjustified windfall gain for the NRF LECs. Without sharing, LEC prices will be constrained neither by regulation nor by competition; LECs will be able to maintain their historic high price levels without any need to flow through the significant cost reductions that have already occurred and that will continue to be experienced in the future. *Where competition is present, LECs will be forced to price on the basis of forward-looking reproduction cost, and under a pure price caps regime they should be required to set their prices on this same forward-looking cost basis even where competition has not yet developed.*

Q. What specific, additional modifications should be made by the Commission if it determines that sharing should be eliminated?

A. Three additional adjustments to the present NRF structure are essential if the Commission determines that sharing and the earnings cap are to be eliminated:

(1) The NRF LECs' rate bases should be revalued based upon TSLRIC, and any write-downs or write-offs engendered by that revaluation should be offset against the gains

in the value of non-book assets and in the overall going-business value of the firm as reflected in the sustained premiums at which investors continue to value LEC shares.

(2) Rates should be reinitialized based upon the revalued rate base and the 10% market-based rate of return adopted by the Commission in D.94-06-011 (the last price cap review) or any revision thereto that the Commission may adopt in the present proceeding.

(3) The X factor should be increased to compensate ratepayers for the loss of the sharing credit and to offset the windfall gain to which the NRF LECs can claim no entitlement.

Going-in rate levels under a "pure price caps" regime need to be reinitialized.

Q. Why does the rate base have to be revalued and the going-in rate level reinitialized if the Commission adopts a "pure price caps" approach?

A. The "going-in" rate level under a "pure price caps" system should be based upon forward-looking costs and not upon historic embedded costs. This would imply that the value of a "pure price cap" LEC's rate base must be based upon the reproduction cost (total service long-run incremental cost) of its plant in service, and not upon historic embedded cost as under RORR. If the TSLRIC reproduction cost of the LEC's infrastructure is less than its historic embedded cost — which it likely will be, given the significant technological improvements that could be applied if the network were built "from scratch" — the various non-cash gains and growth in overall "going business" value of the firm as a whole should be offset against, and hence used to mitigate, any nominal erosion in the economic value of *individual* plant assets.

Aggregate rate levels for "pure price cap" LECs should be reinitialized to reflect the forward-looking reproduction cost of its rate base. If any write-downs in book asset values are required by the adoption of aggregate rate levels based upon forward-looking costs — to the extent that the erosion in the value of individual assets exceeds the appreciation in the overall "going business" value of the firm as a whole[16] — the charge should, for regulatory purposes, first be offset against non-book asset gains before any portion thereof is imposed upon captive ratepayers.

Q. Why is such reinitialization a necessary step in the conversion of NRF to a "pure price cap" regime?

A. Under "pure price caps," NRF LECs would be subject to no upward earnings constraints. The ability of the LECs to maintain their price levels based upon their historic, original cost will be possible *as an economic matter* only under residual noncompetitive market conditions. These conditions will continue to exist, at least for some services and in at least some geographic areas, even after competition is authorized, and will persist until price-constraining effective competition becomes firmly established.[17] Hence, the removal of earnings constraints without reinitialization of rates will simply permit the NRF LECs to price monopolistically in any segment in which effective competition is not

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16. Such a condition is extremely unlikely. Since Pacific Telesis shares are trading in excess of 2.0 times the Company's book value, the "write-down" in the value of the physical telephone plant in service (TPIS) would have to be more than 100% before it exceeded the non-book gain, as reflected in the premium that shareholders are willing to pay for the LEC's shares.

17. In competitive markets, if reproduction cost is less than historic embedded cost, new firms will seek to enter the market if the incumbent(s) try to maintain prices based upon historic embedded cost, and as a result of such entry output prices will be bid down to reflect the lower reproduction costs that the new entrants will confront. If, however, such entry is barred (for legal and/or other reasons), the incumbent(s) will be capable of maintaining their higher output price levels notwithstanding the lower reproduction costs of their fixed assets.

present. Reinitialization of the going-in rate levels based upon forward-looking costs is essential in order to assure a competitive outcome under a "pure price cap" system.

Adoption of "pure price caps" requires that the ongoing price adjustment mechanism be revised to reflect future conditions.

Q. What other changes are required if the Commission is to adopt a "pure price cap" model?

A. As with the case of going-in rate levels, the ongoing price adjustment mechanism must also be revised to reflect future, rather than historic, conditions. As I indicated earlier, the basic productivity methodology that has been relied upon by PacBell and GTEC in the past and, I expect, in this case as well, is founded upon historic conditions and historic output price levels and adjustments that occurred under RORR (pre-1990) or under the present price caps regime (post-1990) which, as I have explained, is itself closely tied to RORR conditions.

Future productivity growth will likely be considerably greater than it has been in the past, for several reasons:

(a) *Exploding pace of technological change*. The rate at which new technology is being introduced into the telecommunications industry is accelerating, significantly reducing the incremental cost of network capacity and reducing the proportion of the most costly element — labor — in the LECs' input mix. And despite substantial growth in the aggregate volume of business, since the onset of NRF some five-and-a-half years ago, Pacific and GTEC have together reduced the size of their work forces by significant amounts, and further reductions are expected.

(b) *Increased competition in the supplier sectors*. Prior to the break-up of the Bell System in 1984, most of a BOC's purchases of equipment and materials were from the manufacturing and supply affiliate of the Bell System — the Western Electric Company. The GTE operating companies had a similar relationship with their manufacturing and supply affiliate, the Automatic Electric Company. Today there is intense competition in the telecommunications equipment market. Purchases are being made at arm's length and discounts and special deals have become the norm, rather than the exception. This intense competition has itself helped to accelerate the pace of technological change and productivity growth *within the supplier segment*, conditions that have resulted in LEC input price growth rates remaining well below the overall economy-wide inflation rate. Indeed, while overall economy-wide price levels rose by some 45% between 1984 and 1992, price index data provided to the FCC by the United States Telephone Association (USTA) in the FCC's CC Docket 94-1 price cap review proceeding[18] indicates that between 1984 and 1992:

- General Support equipment prices fell by 15.7%;
- Central Office Equipment prices fell by 7.3%;
- Transmission equipment costs increased by 7.4%;
- Cable and wire costs increased by 14.5%; and
- Buildings costs increased by 24.1%.

Overall, according to input price data developed by Dr. Laurits Christensen and produced by the USTA in CC Docket 94-1 (and as illustrated in Figure 4 below),[19] LEC input price growth for the period 1984-1992 was at an annual rate of 1.1%, or 2.6% below the annual rate of inflation (GDP-PI) growth during that same period of 3.7%.

18. *Ex parte* filing of the United States Telephone Association to the FCC in CC Docket 94-1, dated February 3, 1995. This document was furnished to the DRA by Pacific Bell in response to a DRA request dated August 24, 1995.

19. FCC CC Docket 94-1, *Response of the USTA to Ad Hoc's Motion to Compel and Motion for Extension of Time*, June 2, 1994.

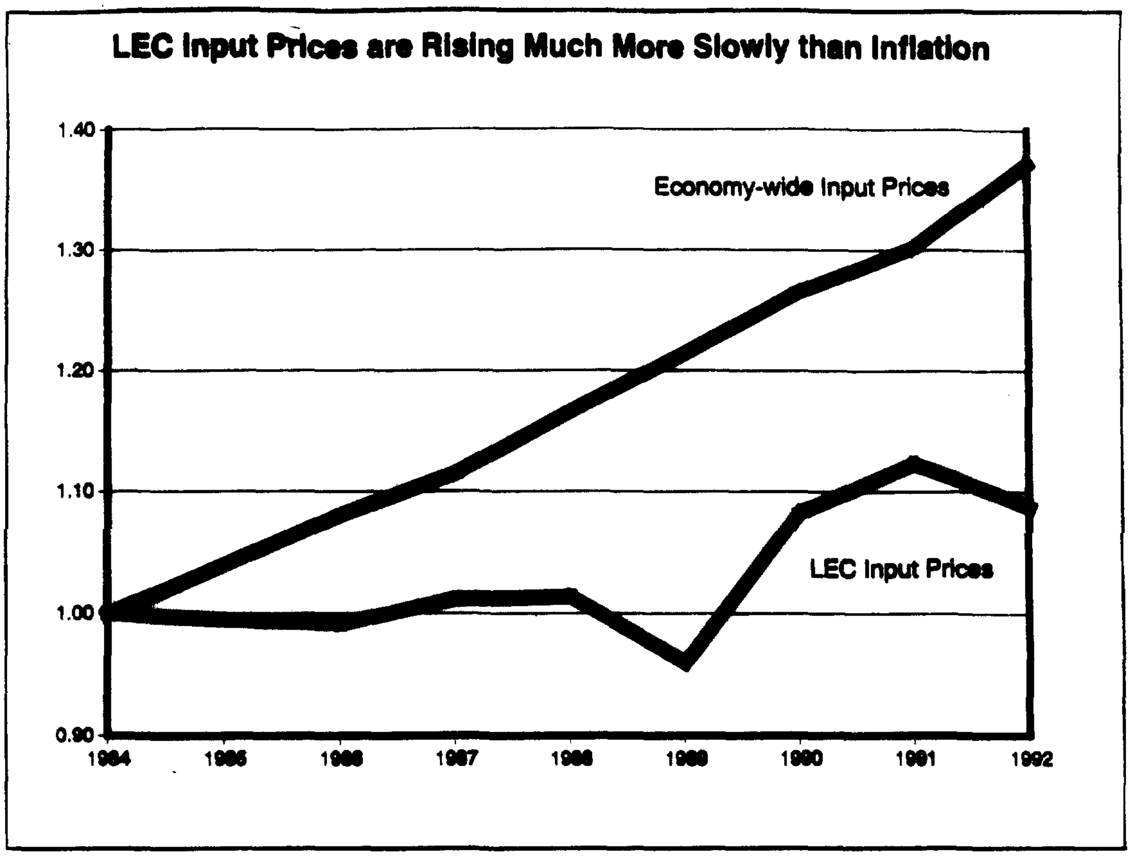

Figure 4

(c) *The future rate of industry demand growth will exceed historic levels.* The demand for telecommunications services in general — and particularly for network services that can exploit available capacity and be produced at extremely low incremental cost — is growing rapidly and is accelerating. The proliferation of new applications, Pcs with modems, on-line services, fax machines, voice mail, among other things,